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By Fax/Original by Federal Express

David S. Guzy, Chief
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Royalty Management Program
Minerals Management Service
P.O. Box 25165, MS 3101
Denver, Colorado 80225-0165

Re: Proposed Oil Valuation Rules

Dear Mr. Guzy:

The following comments are submitted on behalf of the California State Controller's Office to the September 22, 1997 notice of the Minerals Management Service with regard to its pending oil valuation rulemaking.

1. "Alternative" Methodologies

In its notice, MMS requests comments on certain alternatives, proposed primarily by industry, to using NYMEX or ANS prices to value crude oil produced from federal onshore and offshore leases. During this third round of comments, MMS also held a series of workshops across the country to discuss industry's alternatives.

While a great deal of discussion was had during these workshops and several variations of industry's alternatives were proffered, not one proponent of an alternative answered the most fundamental question about its preferred valuation method:

> How will the use of the alternative avoid the problem of undervalued field prices in California?

Unlike the industry proponents of these alternatives, through its prior comments, SCO answered this question. And, the answer is very simple: The alternatives won't work in California to capture the value of federal crude oil.

That this is the only answer is demonstrated by DOI's own Task Force Report; the Long Beach materials reviewed by MMS; the analysis of MMS' own consultants; the recent public testimony during the hearings on an RIK program[1]; and industry's own words. Whether it is called RIK, an affiliate's arm's length purchase, tendering, or a sale by a third party, the result -- which no one in industry has refuted and many have indeed admitted -- is a value related to discredited posted prices.

Indeed, at least as it relates to California, the alternatives offered by industry[2] cannot even be viewed as a good faith response to the very issue that precipitated the MMS rulemaking. Take, for a simple example, proposed benchmark (2) [62 Fed. Reg. at 49462]:

> "The lessee's or its affiliate's arm's length purchases from producers at the lease in the field or area."

One of many pieces of evidence of undervaluation in the field has been the purchase by affiliates of production at posted price, which is then flip sold at higher prices. This practice is not confined to purchases of oil produced from federal leases; nor is it confined to purchases by marketing affiliates from producing affiliates.[3] But industry nonetheless proposes that all production sold non-arm's length be valued on the basis of a practice which is in essence directed at taking advantage of field undervaluation. Moreover, in advancing its alternatives, industry does not even

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[1] Both the written and oral testimony of the Project on Government Oversight, Citizen Action and Timothy Cohelan, Esq. presented during the September 18, 1997 hearing before the Subcommittee on Energy & Mineral Resources, House Committee on Resources, is incorporated by reference herein.

[2] SCO does not exclude from this discussion the alternative proposed by one State under which MMS would generate a value from data reported to it and entered into the AFS system. The flaws of this approach were detailed in SCO's prior comments and those of the State and Tribal Royalty Audit Committee. See also October 10, 1997 letter from the Honorable George Miller and the Honorable Carolyn Maloney to Secretary Bruce Babbitt. In rejecting this approach, SCO does not denigrate the concerns expressed by that State with regard to the valuation proposals for oil produced east of the Rockies. However, as our prior comments indicate, SCO generally supports use of NYMEX based prices as a valid indicator of value and indeed advocated use of NYMEX as a safety net for valuing California crude oil.

[3] See e.g. September 12, 1997 letter from the Honorable Carolyn Maloney to Mr. Larry Nichols, Devon Energy.

bother to address the verification (e.g., document access, "total consideration") or definitional (e.g., significant quantity, field or area) problems associated with its proposals.[4]

As noted, SCO's prior comments, along with those submitted by the City of Long Beach, addressed the flaws of any alternative that would be based on or influenced by undervalued field pricing. These prior analyses, along with the voluminous documentation, equally discount the so-called Conoco "tendering" method. Yet, it became clear during the workshops that this "tendering" method is the "method of the month."[5] For that reason, SCO will briefly outline in greater detail why it opposes any use of "tendering" to value crude oil produced in California.

As a general matter, "tendering" is not consonant with the public interest, or, as the Director recently characterized it in a recent letter to Congress, the "fiduciary responsibilities" of the MMS.[6] "Tendering" is the relatively new creation of one company, Conoco, which was developed in major part simply to derive a price basis upon which to pay royalties. Currently, only two companies, both major integrated companies, are experimenting with "tendering." Only one of those companies, Texaco, conducts business in California. "Tendering" has never been attempted on a nationwide basis, let alone in California. To SCO's knowledge, no government agency has independently audited or investigated a "tendering" program.

As explained by its proponents, "tendering" involves many

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[4] Industry's proposed approaches should be compared to those of California. California, at least, has attempted to accommodate the concerns of independent producers with regard to ANS valuation, despite the fact that a gross proceeds method will result in receipt of less than the true value of federal crude oil.

[5] During the Bakersfield workshop, one economist proffered an alternative that might best be described as the "Delphic dartboard," under which an industry/government group would meet behind closed doors to determine values in California. Leaving aside the antitrust problems with this proposal and the doubtful prospect (as demonstrated by this very rulemaking) that satisfactory agreement could ever be reached, SCO would note that field prices in California have long been determined by industry behind closed doors and that method unfortunately has not proved successful at deriving real value. Moreover, SCO finds it somewhat odd that MMS would even consider putting this option on the table, given its strenuous opposition to delegation of valuation to States during the legislative process leading to RFSA.

[6] September 29, 1997 letter from Director Cynthia Quarterman to the Honorable Slade Gorton.

subjective (and thus disputable) judgments. Some of these judgments involve the same issues that MMS has been unable to define or apply under the 1988 regulations: What is the appropriate field or area? What quantity is sufficient? Should the quantity level fluctuate depending on the available production in the undefined field or area? Should the quantity fluctuate depending on the particular producer's total production vis a vis total production in the undefined field or area. How are quality factors adjusted?

"Tendering" raises problems even beyond those that cripple the application of the 1988 regulations: What is adequate notice to a bidder? How is the bidding pool or acceptable bidder market defined? What qualifications must a bidder have? If advance approval is required, how will a bidding proposal be evaluated? How will bids and results be evaluated?

It was apparently suggested at one workshop that MMS, through a rule, could set the minimum terms of any acceptable "tendering" program. With all respect to MMS, however, it has as yet defined terms key to a "tendering" program, such as "significant quantities" and "field or area," although such terms have been part of the MMS regulations for almost ten years. MMS has had similar difficulties, of even a longer term nature, in applying the major portion analysis for Tribal leases. It has never regularly conducted area market analyses. More recently, MMS has conceded that it was not currently in a position to design a viable RIK program for crude oil and would have to proceed, if at all, only on an experimental basis.

How then can MMS design a rule to govern a "tendering" program applicable on a nationwide basis?[7] After all, "tendering" is simply the other side of the RIK coin.

But even assuming arguendo that a "tendering" program could be designed to work in some area of the Nation, the bottom line is that it will not and cannot work in California. As MMS has recognized, California in large measure is a market separate from that east of the Rockies. It is also a market characterized by a dwindling number of producers and a dwindling number of potential purchasers. Both in terms of total production and refining, the California market is under the control of a handful of major corporations; the same corporations that post prices and the same corporations that internally value California oil by reference to ANS. The California market also lacks one of the keys to any "tendering" program -- an unconstrained, open transportation

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[7] While different "standards" were discussed during the workshop for design of a tendering program (e.g. minimum three bidders), whether these are workable generally or in any particular area or State is currently a matter of guesswork.

system. DOI's Task Force highlighted the transportation constraints in California as one of the primary causes of undervalued field prices.

In short, the basic question still remains unanswered: "How will the use of tendering avoid the problem of undervalued field prices in California?" And, the answer remains the same: The established facts clearly show that "tendering" cannot avoid the California undervaluation problem. "Tendering" has never been attempted in California; it has never, to SCO's knowledge, been contemplated in California. In fact, many industry commenters during the workshops conceded that industry's alternatives, including tendering, might not work in California. Even giving "tendering" the most generous benefit of the doubt possible, in California its use is little more than a crap shoot in a casino owned by the major integrated companies with the odds against the federal government obtaining value.

MMS owes the public and California more than calculating royalties on the basis of a novel and untested experimental method designed initially by a company that doesn't do business in California and used sporadically thousands of miles away in a separate and distinct market.

2. Other Alternative Methodologies

As SCO discussed in its first set of comments, it is confident that basing value on ANS prices is currently the only viable method for valuation of oil produced in California. In those comments, SCO also raised its concern that this might not continue to be true in the future. For that reason SCO recommended that MMS adopt a safety net valuation method for California, based on NYMEX, that would be triggered only if ANS prices dropped to an established level.

Although not discussed directly during the MMS workshops, several matters that were discussed buttress the advisability of establishing such a safety net. For example, during the workshop in Bakersfield, one participant expressed concern that a rise in foreign oil into California could have value impacts. In its original preamble, MMS itself noted that the lifting of the export ban on ANS might impact using it as a marker in the future. And, as one participant in the D.C. workshop noted, the extended nature of the comment periods on valuation rules results in substantial revenue losses; retroactivity, according to MMS, is not an option. Establishing a safety net methodology would reduce the potential for loss during the time that the need for and promulgation of a new rule for valuation of oil in California is debated.

MMS indicated that it would be publishing for comment a new proposal for valuation as a result of the workshops. SCO urges MMS to include the proposed safety net in its next proposal. Finally, as indicated in our original comments, SCO recommends that MMS retain the gross proceeds floor. This too would serve as a safeguard for future market changes. MMS's experience under the 1988 regulations and the protracted nature of this very rulemaking clearly demonstrate the necessity of building into new regulations safeguards for the future.

3. "Marketing" deductions

The most consistent industry complaint about the MMS proposed regulations has been over the so-called "cost free duty to market." Much of the rhetoric on this issue was repeated during the recent workshops. SCO has reviewed industry's comments on this issue and, in its opinion, industry has failed to demonstrate any entitlement to an additional marketing deduction as a matter of law or as a matter of fact.[8]

As MMS is undoubtedly aware, as a matter of law, the issue of whether the duty to market must be performed free of cost to a lessor is one that has been subject to a substantial amount of litigation. There is some degree of disagreement nationwide on what is a deductible or non-deductible expense.[9] What is most

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[8]SCO notes that at least one industry association has claimed that "State representatives at the workshops thought deducting the value of midstream activities was appropriate." That statement is simply false. California representatives attended the workshops and specifically opposed <u>any</u> deduction for so-called midstream marketing activities. Moreover, no State representative agreed to industry's listing of these so-called midstream activities. At most, some State representatives suggested a deduction of no more than a nickel simply as a compromise to end the rhetoric. SCO does not agree with that suggestion.

[9]In the case law, it is almost uniformly recognized that when production is valued at a point away from the lease, the lessee is entitled to an allowance against royalty for transportation (unless the lease specifies otherwise). MMS's practice is consistent with this case law, both in terms of its existing transportation allowance rules and its proposal for location differentials. A clear split in the case law exists on the issue of whether the cost associated with putting production in a marketable condition is deductible. On this issue, some states follow the federal practice, which historically has placed that cost on the lessee. Others require the lessor to share in those costs. <u>See and compare</u>, <u>Garman v. Conoco, Inc.</u>, 886 P.2d 652 (Colo. 1994); <u>Wood v. TXO Production Corp.</u>, 854 P.2d 880 (Okla. 1992); <u>Gilmore v. Superior Oil Co.</u>, 388 P.2d 602 (Kan. 1964); <u>Danciger Oil & Refineries v. Hamill Drilling Co.</u>, 171 S.W. 2d 321 (Tex. 1943). Of course, the federal marketable condition rule stems from the duty to market,

interesting, however, is that SCO has uncovered no case in which a lessee was held entitled to deduct what industry in this rulemaking has characterized as "midstream marketing expenses." In fact, there is no indication in the case law that any lessee ever asserted it was entitled to deduct such costs.[10]

In short, it is safe generalization that until MMS instituted this rulemaking, industry was in near unanimous agreement that marketing expenses are not deductible. There was not a murmur from industry with regard to a marketing deduction during the 1988 rulemaking, although the transportation allowance deduction was predicated on a sale away from the wellhead.[11] There has been no claim and more importantly no proof that marketing practices have changed. The novelty of industry's assertions are further demonstrated by its ill-defined and unquantified listing of marketing expenses that it asserts MMS should consider as adjustments to value based on a marker price, such as ANS or NYMEX. This list ranges from the duplicative to the ridiculous. For example:

- Some industry commenters have asserted that matters like contracting for transportation and environmental risks of undertaking transportation qualify as a deductible marketing expense. Of course, such risks would already be factored into any transportation tariff, and no one has offered any evidence that they are not factored into a location differential.

- Industry has also pointed to the cost of storage. But royalties are calculated on the value as of the date of production. If a lessee stores oil and obtains a higher value due to a later sale, the federal government has never readjusted the lessee's royalty obligation to capture that higher value; nor is the lessee entitled to

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and thus, from the federal perspective, performance of that duty has consistently been viewed as cost free. See California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961). While this alone should serve to dispense with industry's argument, in its comments, industry has insisted that its "duty to market" argument is somehow distinct from the marketable condition rule.

[10] SCO's survey focused on state court cases. As indicated in the preamble to MMS's initially proposed rule, at least one federal lessee has tried, unsuccessfully, to deduct a marketing fee. Walter Oil and Gas Corp., 111 IBLA 260 (1989).

[11] Industry did oppose the marketable condition rule, but as noted, it now asserts that its duty to market argument is somehow different from that rule. 53 Fed. Reg. 1184, 1205 (January 15, 1988).

a credit if its future sale is lower than the value on the date of production. Storage is not, therefore, a deductible expense. In other words, in the calculation of royalties, there is no need for a "time factor" adjustment.

o Industry has spoken to the risk of purchaser default. But as State representatives pointed out at the workshop in Lakewood, this risk also exists if oil is sold at the wellhead. Any cost associated with that risk does not become deductible simply because a lessee sells at a downstream point.

o One marketer and an association have pointed to the fact that marketers provide the service of paying federal royalties for federal lessees. Does industry seriously believe that because it pays someone else to perform this function, it should be permitted to pass on the costs of cutting the federal royalty check to the federal government?

Based on its ill-defined and unquantified list of marketing expenses, industry asserts that adjusting the NYMEX or ANS markers by only location and gravity differentials will overstate wellhead value. Interestingly, in making this argument, industry does not point to one contractual arrangement under which values were discounted or adjusted by factors other than location and gravity differentials. If "marketing expenses" are indeed value enhancements recognized by industry, one must assume that they have already been factored into these differentials. Industry, as noted, has not proved otherwise.

One reason for this failure of proof may be that industry's argument is based on a misconstruction of the type of calculation MMS has proposed to make. A similar argument was attempted in Continental Oil Co. v. United States, 184 F.2d 802, 819-820 (9th Cir. 1950). There one of the defendant-companies argued that the lower court erred in calculating differentials by not factoring in downstream "losses" caused by the mixing crude oils and evaporation of oil during transportation to its ultimate destination. Id. at 820. The court dismissed the argument in one sentence:

> We take it that there is no dispute that ... royalties were to be calculated at values at the wells, not at the pipe line destination, and we think the court was not obliged to take into consideration the factors here mentioned.

Id. In other words, after adjusting for location and gravity, a wellhead value can be derived for use in calculating royalties; the existence of a wellhead value, of course, obviates any need to consider expenses, risks or losses that might be incurred during the actual movement of a particular volume of oil to its eventual destination. In short, industry didn't get it Continental Oil, and continues not to get it today -- the expenses they are talking about are irrelevant to calculating the relative value of oil at point A and point B. In determining relative value, where the production eventually ends up is irrelevant.[12]

Industry, of course, says that part, if not all, of the difference between the field prices and "downstream" market prices is the "value added" by "midstream" marketing activities. This assertion is demonstrably wrong.

One example of the flaws in industry's assertion is shown by a comparison of the spread between average WTS posted prices, adjusted for transportation, and WTS spot prices. Between 1982 and 1985, posted prices remained relatively stable with spot prices wavering above and below postings, as would be expected. Where one must ask is the value added to the "midstream" spot market prices by industry's "midstream" marketing activities during this period? The value discrepancies between WTS posted and spot prices began in 1987 and continued to rise at a steady pace through 1996, with ranges of $1.04 to $2.40. Can the industry seriously claim that its midstream marketing activities or expenses explains this rising discrepancy between posted and spot prices? A similar pattern exists in a comparison of WTI average postings and WTI spot prices, and a comparison of the NYMEX Settle Price with average WTI posted prices. See Attached Graphs.

What these examples show is that the price discrepancy cannot be explained by industry's ill-defined "midstream marketing" expenses. The difference between postings and spot or NYMEX prices does not result from any values added by these marketing activities. Even assuming that midstream marketing activities boost downstream values, they do so in an amount that is statistically insignificant. One company, for example, described its marketing activities as follows:

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[12] At the D.C. workshop one industry participant made clear that industry's complaint largely stems from its view that royalties should be based on what the lessee actually received for the oil. Of course, as one MMS official responded, any derived value to be used in non-arm's length situations will not be based on the lessee's actual receipts; a point that was eventually conceded by the participant. Moreover, simply as a matter of law, it is incorrect to assert that value must equate with actual receipts. United States v. General Petroleum Corp., 73 F.Supp. 225, 235 (S.C. Cal. 1947), aff'd sub nom., Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950). Equally incorrect is the proposition that value must be based on a lessee's net receipts even under a gross proceeds methodology. The marketable condition rule alone shows the fallacy of any argument along these lines.

> Crude oil is purchased at the wellhead and transported by Company-owned trucks or third-party transporters to a trading location where the Company sells the crude oil to a refiner or another purchaser. The Company also purchases crude oil in the spot market at trading locations. The Company's policy is to purchase only crude oil for which it has a market and to structure its sales contracts so that crude oil price flucuations do not materially affect the gross margin which it receives. The crude oil marketing business is characterized by a large volume of transactions with low margins. The Company has generally maintained a gross margin of approximately 2% in its marketing activities for each of the years 1992 through 1996.[13]

And this margin included transportation! In short, industry's "duty to market" emperor is wearing, at most, an unquantifiable pinky ring.

MMS should also seriously question what is actually happening in this so-called midstream market, other than the transportation, gathering and contracting activity that occurred regardless of whether there was a discrepancy between posted prices, spot prices or other indices. What is happening of course is arbitrage: marketers, integrated companies and semi-integrated independents are buying undervalued oil, selling at truer value and pocketing the difference.

It is useful to compare what is happening now to the last period in recent history where there was a marked difference in the oil prices, the price control period. Then, many marketers devised ways to capture some of the difference between the controlled prices and the higher uncontrolled prices. Interestingly, when the Department of Energy questioned these transactions, the marketers justified them on grounds that their marketing activity "added value." DOE, applying a standard based on "historic industry practices," found otherwise. See Mapco International Inc. v. FERC, 993 F.2d 235 (TECA 1993). Rather DOE found that these activities[14] provided no economic benefit other than advancing the self interest of the reseller in obtaining a profit margin. See e.g. AD Energy

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[13] Form 10-K for Plains Resources, Inc. (fiscal yr. 12/96).

[14] Some of the activities DOE addressed bear a striking resemblance to those claimed by industry in this rulemaking. For example, resellers asserted that they: a) bore the risk of loss in taking title and reselling the crude oil involved; b) provided credit and financing; c) arranged for transportation and title transfer; d) sold oil to refiners, resellers and reseller affiliates that would not otherwise been available; and e) entered into sales and exchanges to facilitate the location of oil for refiners. Mapco, 993 F.2d at 244n10.

Inc., 13 DOE ¶83,031 (August 29, 1985).

Of course there are regulatory differences between the situation faced by DOE during price controls and that currently faced by MMS. But the essential facts are the same: a price discrepancy not caused by market activity, which midstream marketers tried to take advantage of through transaction activity, i.e. arbitrage. And, like DOE, MMS should and lawfully can reject the notion that this midstream activity created any benefit that is worthy of administrative recognition.

In essence, industry is saying that MMS should share in the costs industry incurs to profit from the undervaluation of field prices. Thus, for example, a necessary part of industry's "duty to market" argument is that when it decides to transfer marketing costs "downstream" (e.g., through transfer oil to an affiliate for resale or other transfer pricing activity) the nondeductible is transformed into the deductible.[15]

> It would be manifestly unjust for a lessee to sell gas to a subsidiary or to an affiliated firm, person or corporation for a low price and allow that company to extract a larger price in the resale of such product. To allow a lessee to pay royalty out of a shallow pocket while receiving proceeds in a deep pocket would be intolerable.

Exxon Corp. v. Middleton, 571 S.W.2d 349, 358 (Tex. Civ. App. 1978)(emphasis in original), aff'd in part, rev'd in nonrelevant part, 613 S.W.2d 240 (Tex. 1981). See also e.g., Wegman v. Central Transmission, Inc., 499 So. 2d 436 (La. App. 1986), writ denied, 503 So. 2d 478 (La. 1987); Texas Oil & Gas Corp. v. Hagen, 683 S.W. 2d 24 (Tex. App. 1984). It would be equally "intolerable" to force the royalty owner to pay the "transaction" or "marketing" costs associated with such a practice. It is ludicrous to suggest that the federal government should extend a credit to companies who have a vested and demonstrable interest in undervalued field prices for marketing activities that help maintain that undervaluation. All acceptance of this argument would do is put MMS in the position of maintaining the status quo in terms of the discrepancy between field prices and value. This does not benefit the independent producers who are paid on the basis of posted prices and it does not benefit the federal government, which, under MMS' proposals, will continue to receive royalties calculated on the proceeds

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[15] Industry's argument seems to be based on the idea that selling oil at some downstream point is some type of new phenomenon. But this is simply false. MMS's marketable condition rule, for example, has never distinguished, as industry seems to urge, between on-lease and off-lease activities undertaken to market production.

received from these independent producers. As one MMS official noted during the D.C. workshop, MMS can rightfully evaluate the workability of any proposal in terms of the incentives any proposal puts on industry in terms of valuation.

Industry attempts to garner support for its "cost free duty to market" argument by asserting it will impact independent producers. But this argument is a red herring. Under MMS's proposal, independent producers would continue paying royalties on gross proceeds[16] -- they would not be eligible for any "midstream marketing" allowance. Nor, as has been repeatedly asserted, does the recognition of a duty to market push independent producers into index based valuation.

The duty to market is a judicially implied lease obligation. It does not and cannot supplant specific lease or regulatory terms, such as MMS' proposed gross proceeds provision. The duty would only be triggered if MMS could prove that the lessee acted negligently, imprudently or in bad faith. This is a burden more onerous than a simple showing that an independent producer's proceeds were less than indexed value.

Moreover, despite their own rhetoric, independent (non-affiliated) marketers are not impacted by the "cost free duty to market" argument. Such marketers have no royalty obligation to the federal government. Even where they have assumed the task of remitting royalties, they will continue to remit payments on the basis of gross proceeds to the extent that they are purchasing production in arm's length transactions.

In short, the lessees who would benefit by acceptance of industry's "cost free duty to market" argument are those companies profiting from undervalued field prices. By and large, in California these are the same companies that post prices and are the same companies that value California oil internally by reference to ANS. SCO strenuously opposes extending these companies any credit for their marketing behavior.

4. Differentials

Even less of substance was offered by industry during the MMS workshops on the issue of calculation of location and gravity differentials. Of course, such differentials are relevant to the very valuation methods that industry opposes. It has no interest

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[16]Although this has been true of the MMS proposed rule from the outset, SCO notes that it was not until this third round of comments, that industry acknowledged this fact.

in assisting in designing any method for calculating differentials that would enhance the workability of marker crude pricing. Rather, its interest would appear to lie in preserving any procedural challenge it can muster under the Paperwork Reduction Act.

As explained in its first set of comments, SCO too had problems with MMS's proposal for the calculation of differentials. Unlike industry, SCO offered alternatives for MMS to consider. MMS did not seek comments on SCO's alternatives in its September 22 notice.

SCO continues to believe that its proposed alternatives are workable and fair.

a. quality differentials

SCO has consistently stated that the use of gravity bank information from the Four Corners Pipeline system is an appropriate, market-based method for computing quality adjustments between ANS and California crude oils. These quality adjustment factors are used every day by many different participants in the industry (producers, refiners, brokers, etc.) to establish the monetary value of gravity differences of crude oil moved through these pipelines. More significant, however, is the fact that these same companies also use these quality adjustment factors in exchanges involving a wide variety of crude oils and in a manner in which they evaluate quality differences across a broad range of different crude oils.

One industry commenter has argued that gravity banks cannot be used across widely different types of crude oils because such adjustment factors were designed for small variations in quality. This is simply untrue. First, the price/gravity differential across all fields in California is approximately equal to the gravity price differential used to adjust for differences in gravity for a particular field. This indicates that the variation in quality as measured by the gravity difference across widely differing fields in California is the same as the gravity differential within a field (and generally close to the gravity bank in the Four Corners Pipeline). Second, the use of the gravity price differential or the gravity bank value differential by many companies in exchanges involving widely different crude oils indicates that the companies themselves recognize that these factors can be used to value differences in quality across widely different fields. Finally, the gravity banks anticipate application over a wide range of gravity levels because they publish such adjustment factors in their tariffs over a wide range of gravity levels.

More recently, another commenter argued that increasing levels of imports of foreign crude oil into California makes not only the use of the ANS benchmark unreliable but also the application of gravity differentials subject to wild swings depending on the volume of imports. Data from the Energy Information Administration on crude oil imports into California over the last two and a half years do not suggest any trend toward increasing imports or an increase that could likely influence relative quality differentials. Imports into California in 1995 represented about 7 per cent of total crude runs and came from various countries including China, Ecuador, Kuwait, Saudi Arabia and Venezuela. In 1996, imports came from the same areas and represented approximately 6 percent of total refinery runs. For the first half of 1997, imports have again represented about 6 percent of refining runs in California and have come from such diverse areas as China, Australia, Ecuador, Chile, Iraq, and Venezuela. Given the diversity of sources and low volumes of imports into California, we do not see how such imports could currently have a strong influence on relative crude values of California crude oils.

Thus we do not see any reason why MMS should not go ahead and use the gravity adjustment factors in the Four Corners Pipeline tariff as an appropriate, market-driven basis for adjusting for quality differences between ANS and California crude oils. These factors are changed periodically (the gravity bank in the Four Corners Pipeline has changed as often as monthly), and they reflect a market-based method for valuing differences in crude oil quality.[17]

b. location differentials

Calculation of location differentials raises different and more complicated problems, as SCO noted in its comments. For that reason, SCO proposed methods that it recommended MMS use for a set period of three years. After MMS had gathered through audit and reporting a base of information, it would be in a better position to propose a formula approach to calculation of location differentials. This appears to SCO to be a sound compromise approach since it would resolve in a short period of time the reporting burden that industry asserts would result from MMS's original proposal. Of course, it does not address industry's

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[17] If MMS also intends to adjust for sulfur (<u>but see</u> <u>Exxon USA</u>, 121 IBLA 234 (1991)), SCO recommends an adjustment of $0.65 per percent of sulfur; the adjustment that has been applied by industry itself. The All American Pipeline recently changed its sulfur bank differential. Because significant questions exist about All American's new methodology, SCO does not recommend its use. We would suggest that for crude oils that do not vary significantly from the sulfur content of ANS, i.e., crude oils of 2.0% or less sulfur, no separate sulfur adjustment should be made since the gravity bank differential implicitly accounts for minor variations in sulfur.

complaints about the lawfulness of an "interim" rule, which SCO notes as an aside have no legal basis.

In its September 22 notice, MMS asked for comments on various approaches to calculating differentials that can, as a general matter, be characterized as "postage stamp" methods. Devising such a method, of course, could prove more efficient and might reduce administrative reporting costs and burdens. While SCO continues to support the methodology outlined in its original comments, it offers the following "postage stamp" method as a potential alternative. SCO, however, continues to believe that MMS must investigate through audit actual transportation information, including the review and collection of relevant exchange data, so that it can evaluate its regulations and be in the position to make any needed changes on a more timely basis. To that end, SCO also recommends that MMS specifically provide that transportation information be made available for audit.

As noted in its original comments, SCO agrees with the general premise that the index value should be adjusted for the actual cost of moving crude oil from the lease to the market center. In this regard, we reiterate that the only type of relevant information for determining location differentials is from "in/out" exchanges, i.e., exchanges of the form "A places crude in B's pipeline and B delivers an equal volume of the same or similar crude back to A at a point further down the pipeline." Other exchanges containing location differentials in which the crude receipt and delivery points are not on the same pipeline do not necessarily provide meaningful information for determining transportation costs from lease to market centers.

In our experience in California there are a significant number of such "in/out" exchanges so that meaningful transportation cost factors from a lease to a market center might be developed onshore. In fact many such transactions do occur at the lease and involve movements directly to market centers. Therefore, it may be possible to develop transportation cost factors from particular producing areas in California to market centers without necessarily worrying about particular aggregation points.[18]

Another important and somewhat unique fact about federal royalty production in California is that it is concentrated in only a few areas and thus there is no need to develop a large number of

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[18] Of course, such an approach risks including non-deductible gathering in the location differential. Until more information is obtained about how these differentials are calculated, adjusting for gathering may not be feasible, which is another reason that SCO believes MMS should move forward subject to further audit review and future changes. SCO continues to oppose any deduction for gathering costs.

different transportation cost factors involving areas where there is no federal royalty production. For example, onshore royalty production in California is concentrated primarily in the southern portion of the San Joaquin Valley. Approximately 80 per cent of onshore federal royalty production comes from the Midway-Sunset/Cymric/McKittrick area and another 9 per cent comes from the Lost Hills/Coalinga/Kern area. This leaves only about another 10 percent and much of that comes from the Sespe/South Mountain/Placerita area. Thus, one option would be to use geographic zones, keyed to areas in which federal royalty production is concentrated as the basis for computing transportation costs.

The next step is to determine what the proper transportation costs should be for each zone. As an initial starting point, SCO proposes that MMS use the data compiled in the course of the Long Beach litigation, various audits of oil company contracts, and other information relating to transportation costs.[19] These data are from "in/out" transactions for various areas in California and provide the basis for an average cost figure for transportation. From this data the approximate cost to move crude oil from certain areas such as the San Joaquin Valley to refining centers in Los Angeles and San Francisco can be determined. In addition, as outlined in prior comments, the transportation destination used in deriving this adjustment factor should be to the nearest (and most economic) destination.

This approach would yeild the following estimated results for onshore geographic zones.

ZONE	RATE($/BbL)
Northern San Joaquin Valley (180-240 miles) Belridge north, including Lost Hills, Coalinga, Kettleman	$0.70
Southern San Joaquin Valley (120-150 miles) McKittrick south, including Cymric, Midway-Sunset, Kern, Mt. Poso	$0.50
Ventura County (55-90 miles) Sespe, Placerita, South Mountain	$0.35
Los Angeles area (0-40 miles) Sawtelle, other areas in L.A. Basin	$0.20

[19] MMS has had the opportunity to review these records as part of the Interagency Task Force's investigation of California royalties. In addition data from the Reserved Pipeline Case on in/out exchanges is publicly available.

Determining location differentials for offshore production is somewhat more complicated because of the limited transportation options for some offshore locations. Many of the OCS fields, therefore, represent separate transportation zones, and SCO has taken that approach in developing this alternative means for calculating location differentials. Based on the analysis described above for onshore areas, the estimated cost to move heavy California crude oil through heated pipelines on a per barrel mile basis can be calculated, which provides a basis for applying transportation costs more generally throughout the State including for OCS produced oil.[20]

This approach would yeild the following estimated results for offshore geographic areas.

ZONE	RATE($/BbL)
Beta	$0.75
Santa Clara	$1.20
Dos Cuadros, Carpenteria, Summerland	$0.50
Hondo (Santa Ynez Unit)/Pt. Arguello	$1.20
Pt. Pedernales	$0.75

We believe that these estimated differentials for both offshore and onshore production are quite consistent with actual transportation costs.

These transportation cost factors could be adjusted at a rate not to exceed the annual increase or decrease in the "Fuels Power Index" of the Producer Price Index. This index measures increases or decreases in the cost of energy fuels and electric power, which are the primary components in the cost of operating a pipeline, and thus should serve as a reliable means of tracking changes in the cost of transportation. It is our understanding that the method outlined above is consistent with the approach for deducting transportation costs taken by Chevron, one of the largest royalty payors in California, in its settlement of the Texas royalty issues.

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[20] Attached to these comments is a schematic map of California depicting the zones used under this proposed alternative. Because one industry participant at the D.C. workshop expressed concern that location differentials might result in royalty loss to the government, we have also attached a graph that demonstrates the actual operation of the alternative set out above.

SCO reiterates its view, however, that any method that MMS eventually selects for calculating differentials should be subject to monitoring and, at the least, audit investigation. We continue to believe that an appropriate regulatory approach would be to provide that calculation of differentials will be reviewed after a "sunset" period of three years, similar to the approach adopted by BLM for royalty rate reductions.

5. Tracing Exchanges

SCO understands that there was some discussion during the workshops in Houston on the feasibility of tracing transfers of crude oil through multiple exchanges to an eventual outright arm's length sale. No one, however, apparently addressed how MMS could achieve this and still guard against the type of "daisy chain" transactions that were prevalent during the price control era, that often involve "arm's length" transactions, and that can be used to mask values. Moreover, SCO respectfully reminds MMS of the difficulties of tracing, matching and identifying exchanges that it discovered during its Task Force investigation. As noted in prior comments, SCO does not support any expansion of the gross proceeds rule that would involve tracing production through multiple exchanges.

6. Conclusion

MMS's September 22 re-opening of the comment period on the oil valuation regulations and its round of workshops was done largely at the urging of industry and industry's insistence that viable alternatives to MMS's originally proposed rules exist. The only thing that was achieved through MMS's September 22 notice, however, was costly delay. Industry, inter alia:

o has not offered alternatives that resolve or avoid the problems of field undervaluation;

o has not offered alternatives that resolve the interpretive uncertainties and problems that MMS's own experience demonstrates are associated with current regulations;

o has not demonstrated how, under what circumstances or to what extent payment on the basis of arm's length gross proceeds would be disallowed to independent producers;

o has not identified or quantified the "midstream" marketing expenses incurred by integrated and larger semi-integrated independents that allegedly "add value" to oil production;

o has not proved that the disparity between posted prices

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o has not identified or quantified the "midstream" marketing expenses incurred by integrated and larger semi-integrated independents that allegedly "add value" to oil production;

o has not proved that the disparity between posted prices and spot or index prices is attributable to "midstream" marketing activities; and

o has not assisted in resolving any problems that may accompany the calculation of quality and location differentials.

What industry has done is stall. During the workshops attended by SCO, we heard repeated assertions that industry and its associations had "not thought it through;" had "not had time to poll its members"; and that they "needed more time." But the workshops were held to address <u>industry's alternatives</u>. Indeed, if industry (as one association suggested in its comments) is seriously concerned about continuing the dialogue, if it (as some members suggested during the D.C. workshop) is seriously concerned about the State and federal governments' royalty income, industry would support MMS's suggestion on adopting an interim final rule. Yet, industry vehemently opposed MMS's suggestion.

Moreover, industry has had ample time. MMS published an advanced notice of proposed rulemaking on oil valuation in December 1995 -- nearly two years ago. The Task Force report, which indicated a need for regulatory change, was issued in May 1996. MMS's Royalty Policy Committee had a subcommittee on valuation with changes to the oil rules on its agenda; industry -- independents and majors -- <u>refused</u> to participate. Nine months have gone by since MMS published its original rule.

Substantial evidence exists of undervaluation of field prices, particularly in California. Substantial evidence exists that the current rules will result in value based on posted prices, whether or not the term "posted price" is excised. Substantial evidence exists that MMS, based on its own experience, cannot access the documentation to conduct any sort of comparable sales analysis. Substantial evidence exists, based on MMS's own experience, that it cannot resolve the issues of comparability, field or area, or significant quantities that plague both the existing rules and industry's proposed alternatives. Substantial evidence exists that currently the only viable alternative for valuation of crude oil produced in California is by reference to Alaskan North Slope prices.

SCO has been supportive of MMS's regulatory initiative on the crude oil valuation regulations. SCO is not unsympathetic to the political pressures MMS is facing because of industry's well-financed campaign against the regulatory initiative. SCO understands MMS's desire to produce a record that shows that it provided interested parties every opportunity to state their positions and substantiate their claims.

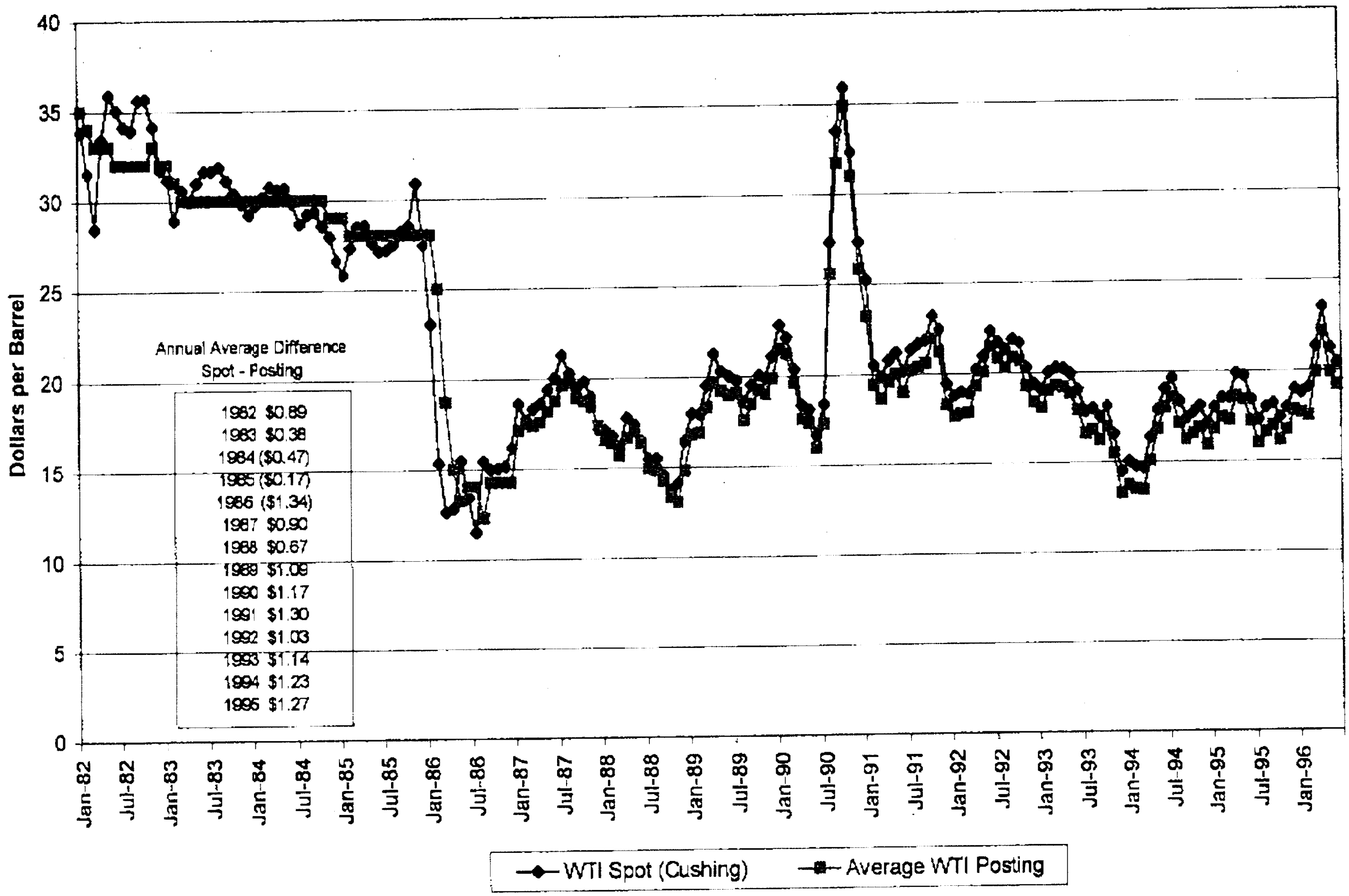
But it is now time to move forward on finalizing a rule for valuing crude oil. Especially as it regards California, there is simply no sound reason for further delay. SCO stands ready to assist MMS in any manner that it can to expedite finalization of the proposed oil valuation rules.

Sincerely,

Lee Helfrich

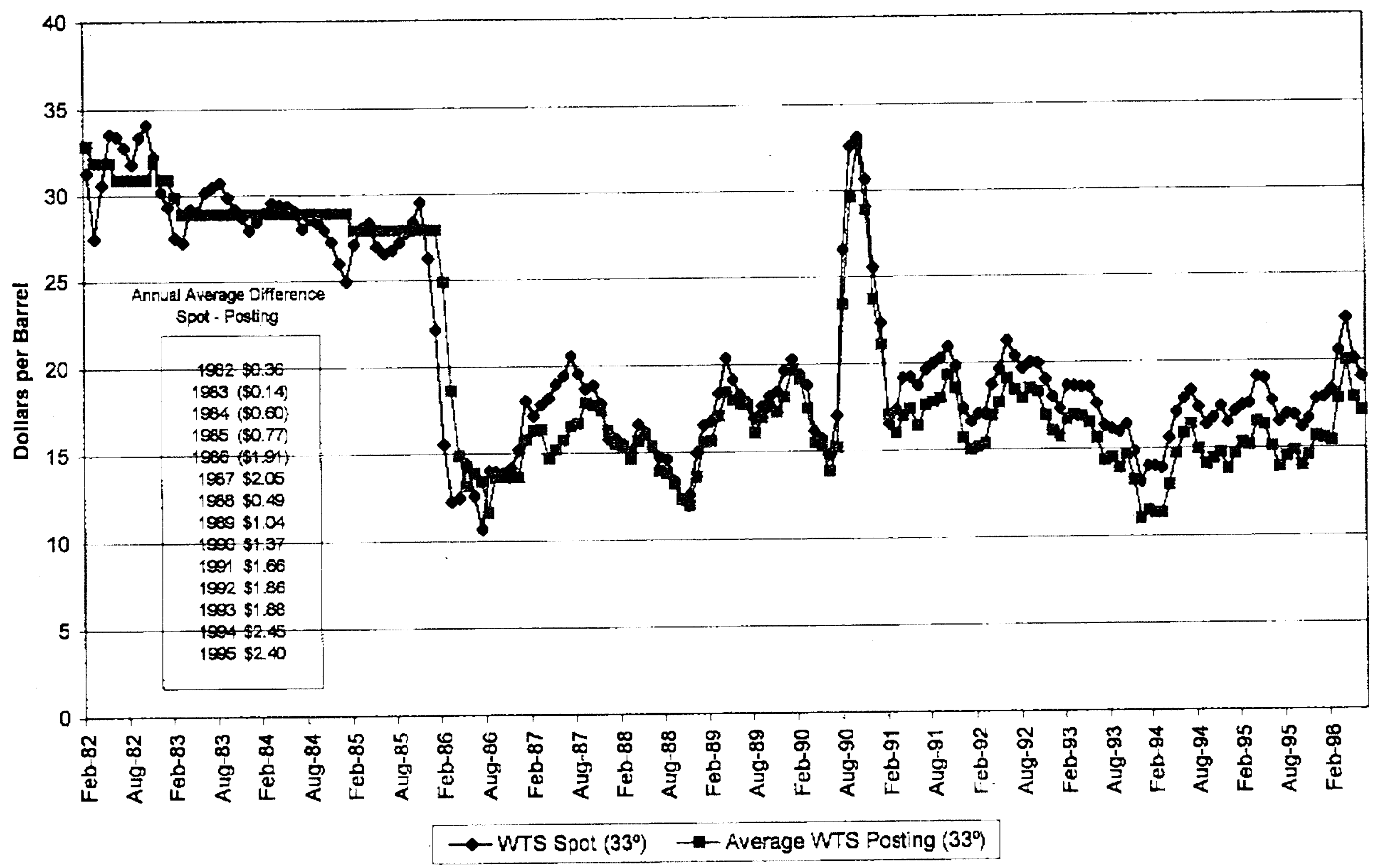
Henry Banta

Comparsion of WTI Spot Price with Average WTI Posting



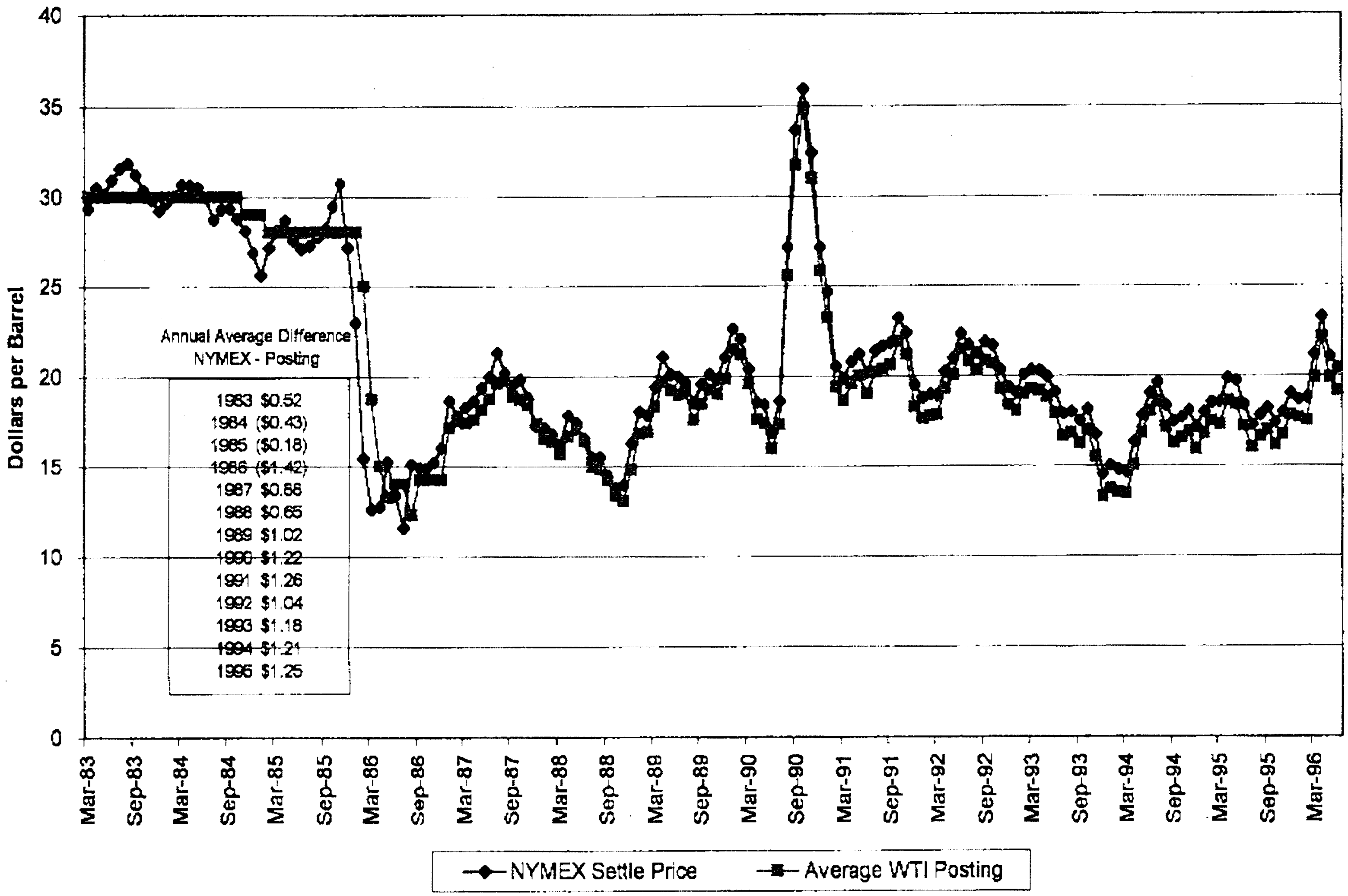
Note: All prices are monthly averages.
Sources: Oil and Gas Journal Energy Database, Platt's, Oil Company Posted Price Bulletins

Comparsion of WTS Spot Price with Average WTS Posting



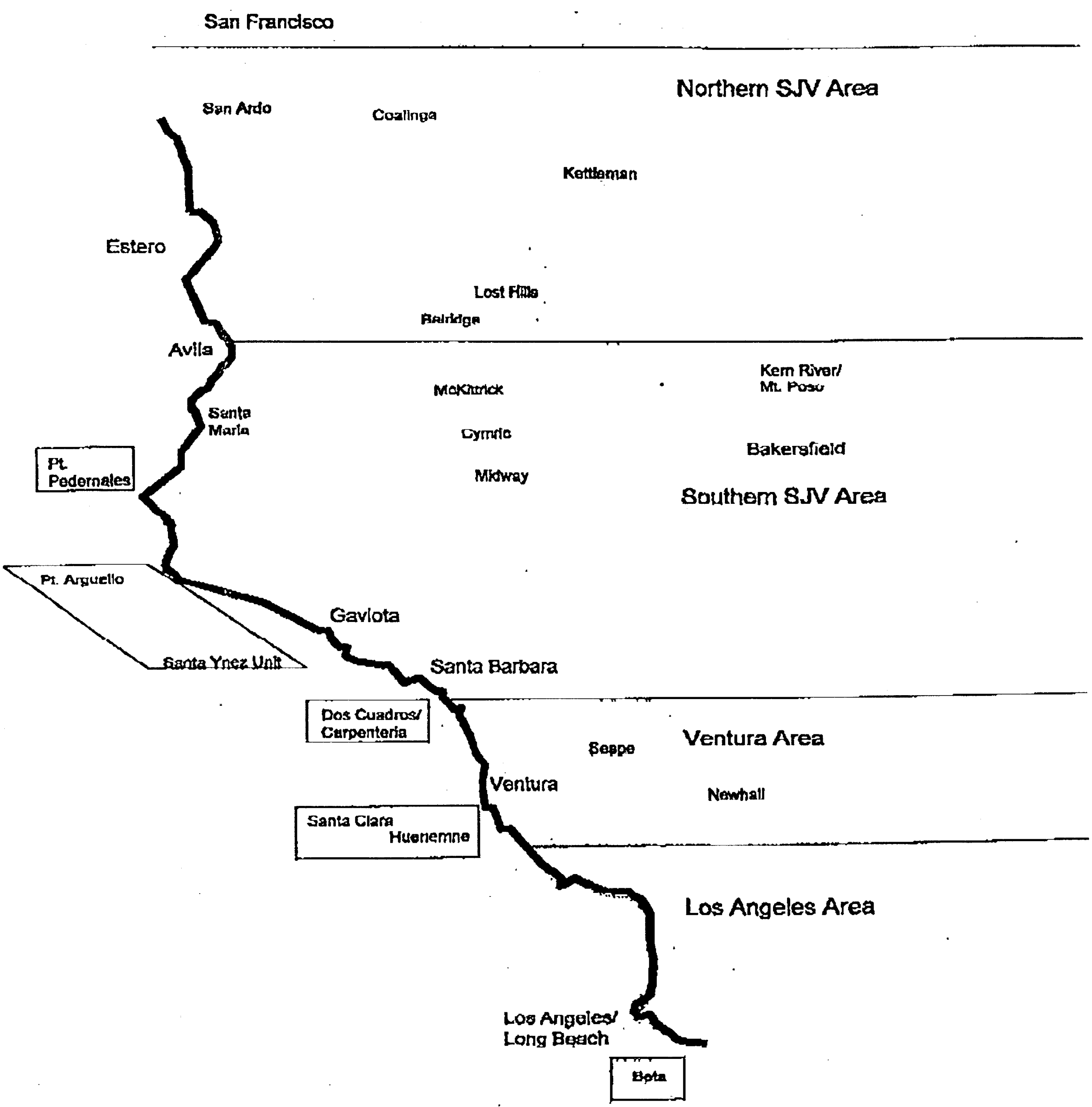
Note: All prices are monthly averages.
Sources: Oil and Gas Journal Energy Database, Platt's, Oil Company Posted Price Bulletins

Comparison of NYMEX Settle Price with Average WTI Posting



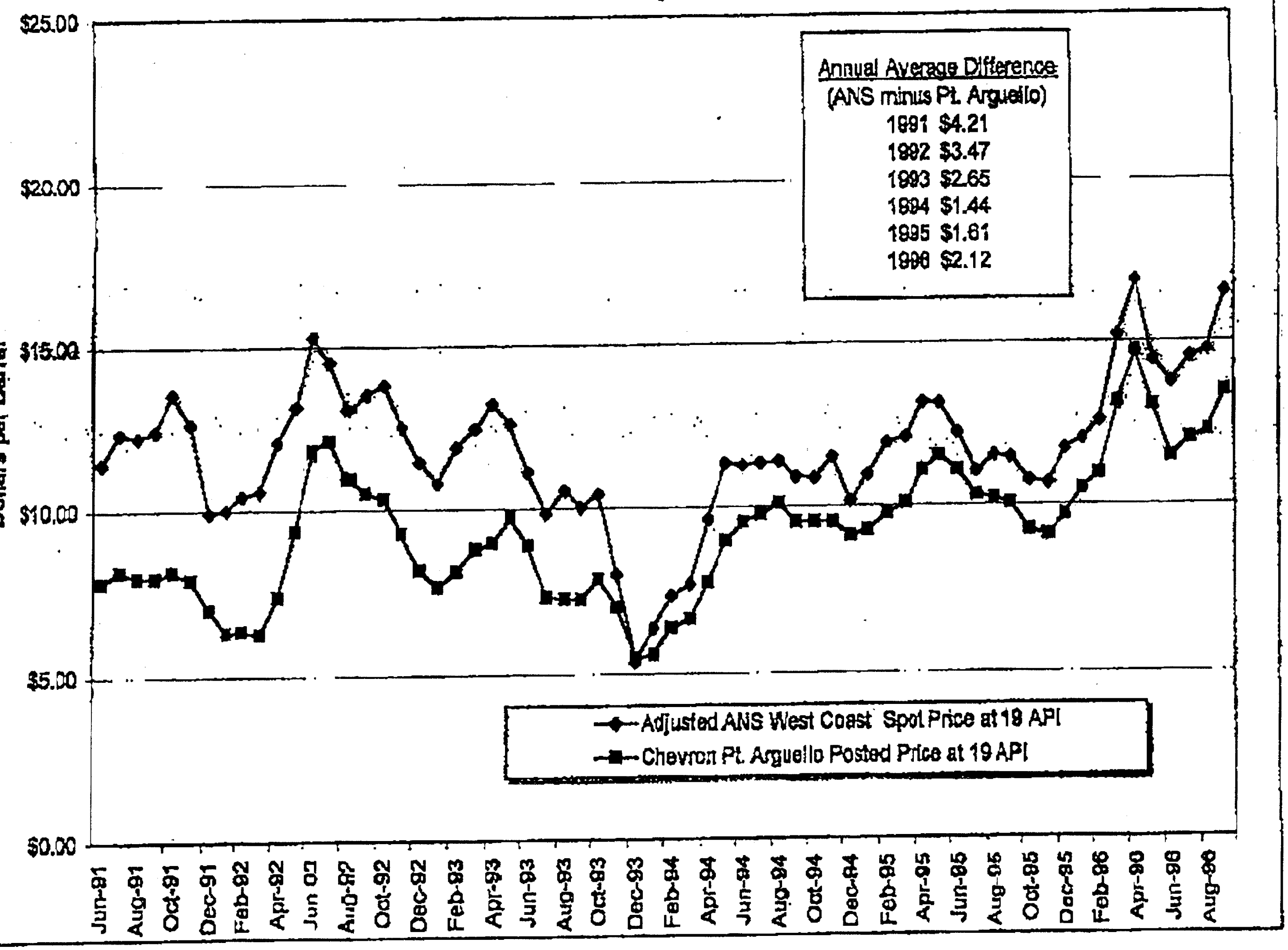
Note: All prices are monthly averages.
Sources: Oil and Gas Journal Energy Database, Reuter's, Oil Company Posted Price Bulletins

California Transportation Zones



FROM : LOBEL NOVINS LAMONT

Adjusted ANS West Coast Spot Price vs. Pt. Arguello Posted Price
June 1991-Sept 1996



ANS adjusted for gravity, sulfur, and transportation.
Source DRI/Platt's and Chevron's posted price bulletins.